

Catalyst

A topical newsletter for privately held businesses

Summer 2009

With the summer upon us, we here at Grant Thornton LLP remain hopeful that the arrival of the milder weather will bring with it a warming to the chill we've been feeling in the economy over the past year. Many privately held businesses have been forced into action and have had to take measures to mitigate the effects of the economic downturn.

Factor in the increasingly complex issues presented by today's business environment and it's no wonder that planning for retirement and the succession of their business may have fallen to the end of the to-do list for numerous privately held business owners. But for many, now's the time to revisit—and reprioritize—that list.

According to Statistics Canada, Canada's elderly population is growing. Demographics show that in 2007, 13% of Canadians were over 65. With a significant number of baby boomers reaching the age of retirement within the next several years, that trend is expected to accelerate—projected to reach 27%

by 2056.¹ Whether the owners of privately held businesses included in this group decide to leave their businesses early, or carry on for many years to come, it's crucial that they get started on their succession and estate planning long before retirement.

In this issue,

- we speak with Genevieve Taylor, a Principal at Legacy Tax + Trust Lawyers in Vancouver on estate litigation issues relevant to owners of privately held business;
- we discuss some tools for an effective—and money-saving—succession and estate plan; and
- we discuss the legal and tax implications of joint accounts.

Lester R. Bittel once wrote that “Good plans shape good decisions. That's why good planning helps to make elusive dreams come true.”² And for many owners of privately held businesses, their business is the embodiment of that dream. A well thought-out succession and estate plan can

allow that dream to live on for future generations.

Gary Dent
National Leader, Tax Services
Grant Thornton

¹ Source: Statistics Canada, http://www41.statcan.gc.ca/2008/70000/ceb70000_000-eng.htm, (accessed June 2, 2009).

² Bittel, Lester, R. *The Nine Master Keys of Management*. New York: McGraw-Hill, 1972.

Contents

- 01 Welcome
- 02 Estate litigation and privately held business—planning ahead to avoid the pitfalls
- 03 Succession and estate planning—keeping the family happy and the tax man at bay
- 04 Joint ownership of bank and investment accounts—a valuable estate planning tool, if done right

Estate litigation and privately held business —planning ahead to avoid the pitfalls

Grant Thornton succession and estate planning professionals, Kay Gray and Janet Newcombe, recently spoke with Genevieve Taylor, Principal at Legacy Tax + Trust Lawyers in Vancouver to obtain her perspective on some of the more common litigation issues that may arise from a poorly thought-out estate plan. They also discussed some tips on how to avoid making these mistakes—before it's too late.

What are some of the common issues you see brought to litigation that pertain specifically to privately held businesses?

Genevieve: The valuation of private company shares. For example, litigation can arise in a situation where one child receives the shares from the estate and the other children argue that the shares are undervalued and therefore, the value of assets they receive should be adjusted accordingly. There's a lot of scope for arguing about the value of privately held shares since there is often no market for the shares.

Litigation relating to the change in control on the succession of the business, either during the lifetime of a primary shareholder(s) or after their death, is also common. If, after the death of the parents for instance, one child obtains voting control of the family company and the other children have participating shares in the company, the decisions of the child who now controls the company affect the wealth of the other children. This can lead to disputes.

Can you explain what “dependant relief legislation” is? What are its effects?

Genevieve: All of the common law provinces have some form of dependant's relief legislation that permits dependants to ask for support from an estate where a will has not adequately provided for them. The persons entitled to bring claims under this legislation vary by province. In British Columbia, for example, the relevant legislation is called the *Wills Variation Act*, which has broad application in comparison to other provinces and results in more litigation. It permits any spouse or child of a deceased person to bring a claim to vary a will even if he or she was not dependent upon the deceased.

Can the use of a trust as a planning tool help to avoid possible litigation under the above legislation?

Genevieve: Yes. When an individual transfers all or some of their assets to a trust during his or her lifetime, it can be quite an effective tool to avoid claims under dependant relief legislation. After the death of the individual, the assets are distributed from the trust based on the terms of the trust

rather than from the estate. The assets distributed from the trust are not subject to claims under the relevant legislation or probate fees. In a recent court case in British Columbia, the judge confirmed the legitimacy of this planning. The trust must be a valid trust in that it must be properly settled and managed, and cannot be a sham. Your readers should note, however, that this strategy may not work in all provinces, and they should consult with their adviser on the particulars.

For owners of a privately held business, what planning could be implemented to protect the business (and other shareholders) from a breakdown in a shareholder's marriage?

Genevieve: Family law relating to marriage breakdown varies by province. In general, there should be a planned course of action for the family business in the event of a marriage breakdown. The plan should be legally documented in a pre-nuptial agreement, a shareholders' agreement, family trust agreement or some combination of the three. This planning will minimize the chance of litigation and the possibility of the shareholders having to manage the business with or for the ex-spouse.

What other estate planning can an individual do to avoid or minimize litigation?

Genevieve: Documenting their intentions in their wills and considering a trust is a good first step. It's also beneficial to discuss the estate plan with the beneficiaries ahead of time so that they understand the rationale and are not surprised. For instance, if an individual plans to create a discretionary trust with a corporate trustee upon their death to hold assets for the benefit of a child, the reasons for this plan, such as protecting assets in case of marriage breakdown or preserving disability benefits, should be communicated to the child. Without this understanding, the child could be more likely to object to the trust arrangement after death and resort to litigation.

There should also be careful consideration given to the individuals chosen as the executors of an estate or the trustees of a trust. Litigation can often result if the executors don't work well together or if the executor and the beneficiaries don't have a good relationship. Where conflict is anticipated, corporate trustees should be considered for objectivity rather than individuals that are personally involved. Corporate trustees can cost more money in terms of fees, but it may result in significant savings in the long run if litigation can be avoided.

Succession and estate planning—keeping the family happy and the tax man at bay

By Gerry Popp and Armando Minicucci, succession and estate planning professionals, Grant Thornton

“Succession and estate planning” is a term we hear often, but what does it mean? And how does it apply to privately held businesses? In the same way that business owners have a strategic plan for the business operations, a strategic plan is also required for ownership of the business, both now and in the future. How a successor is chosen and trained, and how and when ownership and control of the business is transferred, are just a few of the questions that need to be addressed when putting a succession strategy in place.

When it comes to the transfer of personal wealth, a custom-tailored estate plan is the best way to achieve objectives. As a privately held business owner, you have options that can help you come up with a succession and estate plan that is not only effective, but could potentially save you money.

Here are some of the strategies that can help you along the way to ensuring a smooth transition of both your business and your personal wealth. Some you’ll be familiar with, while others, maybe less so. Either way, depending on your needs—or the needs of your business—they can all be effective succession and estate planning tools.

Will

A will is the most important document for an estate plan. Not only is an effectively structured will one of the ways to ensure that your possessions and assets are distributed according to your wishes, it’s also a legally enforceable document, providing an effective tool for ensuring that the interests of your loved ones are

safeguarded upon your death. And given the complexities surrounding the tax liabilities that are due from your estate upon death, a properly drafted will can also provide significant tax savings opportunities.

Shareholders’ agreements

In a corporation where there is more than one shareholder, a shareholders’ agreement is critical in establishing their ongoing rights and responsibilities in the succession—both in the ownership and the administration—of the company. With good tax planning, a shareholders’ agreement will allow for the business to carry on in the event of disability and minimize the tax liability of the estate. Equally important, it may enable the remaining shareholders to carry on the business with a minimum drain on cash flow, which, in challenging economic times, could be the key to survival.

Estate freeze

An estate freeze is a tax planning strategy by which the future growth of an asset, including shares of a private business, is passed on to other persons, usually your children. In the current economic environment characterized by reduced investment values, it’s a technique that may be very strategic and timely for shareholders. Take the following example.

A married couple are the current shareholders of a company worth \$5 million. They “freeze” their company by exchanging their current common shares for special shares that have a fixed value of \$5 million. New common shares are issued to new shareholders, in this instance their children. Any growth in the value of the company accrues to the new common shareholders and is tax-deferred through their lifetimes.

Additionally, the final tax liability of the couple’s estate is “frozen,” and may be reduced as they redeem the shares and

use the funds during their lifetimes. Life insurance or other planning may be implemented to avoid putting a strain on the family’s resources to pay the tax liability on death.

Over the next few years, if the value of the company’s assets drops below the value of the special shares owned, the couple can “re-freeze” the shares. This permits the new special shares to be issued at a lower value, further reducing the shareholder’s ultimate tax liability—allowing the next generation to benefit from the market up-tick when it occurs.

Trusts

The benefits of an estate freeze are further enhanced if a discretionary family trust is used to hold the new common shares in the private company, allowing the original shareholder(s) to maintain control of the company and the underlying assets. A family trust would typically be structured to benefit the individual’s children and grandchildren, at the discretion of the trustee(s), permitting flexibility and control over the shares the trust owns in the company.

There may also be immediate tax benefits to using family trusts. During the time that the family trust owns the shares, dividends paid by the company could be distributed through the trust to one or more of the family members, allowing income-splitting with adult children who are still somewhat financially dependent upon the parents or grandparents. For example, a family member who resides in Ontario and has no other sources of income for the year but dividends may receive between \$37,500 and \$50,300 in dividends—depending on the type of dividend—from a private company in 2009 and pay little or no tax.

continued on back

Further tax benefits can be enjoyed if the company's shares are eventually sold and the trust's resulting capital gain is shared among all the family members. If the shares qualify at the time of the sale, each family member could utilize his or her lifetime capital gains deduction to realize up to \$750,000 of capital gains tax-free.

A plan that's right for you

Like a puzzle, there are many pieces to a succession and estate plan, and they all have to fit together in order for the strategy to succeed. Privately held businesses, like their owners, are unique, and so a succession and estate plan must be customized. In the long run, the time

preparing a plan is well spent, especially if it helps you avoid the potential issues discussed on the previous page.

More information regarding an estate freeze or re-freeze can be found in the Grant Thornton white paper entitled "The big freeze," available at www.GrantThornton.ca/insights.

Joint ownership of bank and investment accounts—a valuable estate planning tool, if done right

By Daniel Castonguay, Tax Services, Grant Thornton

It's common practice for aging parents to transfer assets into joint accounts with their adult children in order to have that child assist them in managing their financial affairs. Such strategies are also used for estate planning purposes, such as probate avoidance. However, as useful as this practice can be, there are some legal and income tax ramifications that you should consider before deciding if this strategy is right for you.

The proof is in the documentation.

When done properly, joint management of bank and investment accounts can be a very effective tool for estate planning purposes. But it's not always cut and dried. Recent decisions by the Supreme Court of Canada have addressed the importance of proper documentation¹—that when a parent puts an adult child's name on his or her bank or investment account for no consideration, it's presumed that the account still belongs to the parent.

If you really intend for your adult child to be the joint owner of the account, you need to document it properly, since your adult child may have to prove this intention after your death to obtain ownership of the account. Without proper documentation, the account will not pass to them automatically, and instead will form part of your estate. The assets in the account will now be subject to probate fees, thus defeating the purpose of a joint ownership arrangement in the first place.

And, there's always the tax considerations.

Ensuring that proper documentation is in place is only one part of the equation. There are also important tax implications to consider. There is a partial disposition (for example, 50%) of the assets in the account for tax purposes at the time of transfer to an adult child. Based on the value of the account, this may result in a prepayment of tax, since income tax is due at the time of transfer into joint ownership rather than at death, when there is a deemed disposition of all assets at fair market value. However, if the investment account has declined in value,

you may realize the loss on the transfer to the adult child.

The rules are different when you transfer accounts into joint ownership with a spouse or a minor child. It's normally assumed that you intended to make a gift to your spouse or minor child and therefore, the assets are jointly owned. For tax purposes, the transfer is considered a disposition, and so, there may be tax payable. But note: transfers between spouses can occur on a tax deferred basis.

The final word?

You want to avoid confusion, potentially acrimonious and expensive legal battles, ill feelings among family members, and unexpected tax bills. Being able to preserve wealth for your beneficiaries while circumventing legal and family relationship pitfalls is what estate planning is all about. And with proper documentation and sound tax planning, transferring bank and investment accounts into joint ownership with a family member can be an effective tool.

¹ Pecore v. Pecore, [2007] 1 S.C.R. 795, 2007 SCC and Madsen Estate v. Saylor, [2007] 1 S.C.R. 838, 2007 SCC 18)

We hope you enjoyed this edition of *Catalyst*. Your comments on the topics covered here are welcome. Contact us at editor@GrantThornton.ca. For more Grant Thornton publications for privately held business, visit www.GrantThornton.ca/insights.

© Grant Thornton LLP. We have made every effort to ensure information in this publication is accurate as of its issue date. Nevertheless, information or views expressed herein are neither official statements of position, nor should they be considered technical advice for you or your organization without consulting a professional business adviser. For more information about this topic, please contact your Grant Thornton adviser. If you do not have an adviser, please contact us. We are happy to help.

www.GrantThornton.ca

Audit • Tax • Advisory
Grant Thornton LLP. A Canadian Member of Grant Thornton International Ltd

© 2009 Grant Thornton International Ltd. All Rights Reserved.
Grant Thornton International Ltd and the member firms are not a worldwide partnership. Services are delivered by the member firms independently.

Published by:
Grant Thornton LLP

Editor-in-chief:
Linda LeBel
E llebel@GrantThornton.ca

Editor:
Jennifer Hawkes
E jhawkes@GrantThornton.ca

Production manager & graphic designer:
David Baker
E dbaker@GrantThornton.ca